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Economic Conditions
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General Business Conditions

THE industries and the commodity markets have had another busy month in October. For the most part manufacturers have continued to sell more than they are shipping, and their unfilled orders have piled up further. The tendency of buying to spread around the circle has been demonstrated again. Manufacturers can see a high rate of operations ahead for some time. When they sell for future delivery at fixed prices it is only prudent to cover future needs for materials. They are concerned lest their sources of supply get tied up with government orders, which has already happened in certain cases. They hear talk of possible priorities in some lines, or of inflation. They are no longer fearful of an early British defeat or of a slump in exports of steel and other war supplies. For all these reasons, they have lengthened their commitments for materials, usually into the first quarter of 1941 or later; and prices of these materials have been strong.

So far as trade and market reports show, preoccupation with the Presidential campaign has had no visible retarding effect. There never was much factual support for the belief that a Presidential election slows down business; and although in this campaign economic policies are a major issue, and the election appears so close that the result cannot have been foretold or discounted, the uncertainty has not checked the upswing stimulated by the defense preparations.

New Orders Exceed Peak of Last Fall

In lines related to the defense program, where forward buying is naturally most pronounced, sales during the past two or three months compare favorably with any similar period on record. An index of new orders compiled by the National Industrial Conference Board, which is based on reports from about 700 manufacturers, in September climbed above the peak reached during the rush last Fall, following the outbreak of war. This was the sixth consecutive monthly rise, and the increase was the greatest in any month of the six. During October new business has naturally slackened in some of the industries which have been most active, but it has held at high levels, and other lines have come forward.

Steel orders, according to the trade reviews, have been larger than in September and have exceeded production. In September domestic sales of copper totaled 254,976 tons, nearly three times the consumption in that month; nevertheless, in October they have again exceeded consumption with a total around 120,000 tons. Heavy buying of copper almost always signifies equivalent sales of brass and other fabricated products, which is evidence that fabricators are sold well ahead. Zinc sales, likewise exceptionally heavy in September, have been smaller but also in good volume. Lead sales have improved and the price has been marked up.

Contract awards under the defense program have not equalled the September figures, which were swollen by the inclusion of the two-ocean navy and airplane and ordnance contracts on which production is still months away. However, contracts for apparel and equipment which can be put into production at an early date have been substantial. In woolen goods, and in such cotton goods as twills and ducks, these orders dominate the markets. They have virtually compelled trade buyers to cover, at advancing prices. Textile business generally has been as active as in September and in the aggregate possibly larger, due to the spurt in woolens. Leather and shoe business is good and tanners have bought hides freely.

The sold-up condition of the machine tools manufacturers, and of most other machinery and equipment industries, requires no fresh description. Building contract awards have moved ahead, and include a substantial number of contracts for new plants. In the first half of October daily average building awards were 7 per cent higher than in September and 42 per cent above a year ago, continuing the level of construction activity at the highest since 1930.

Order Backlogs Assure Heavy Production

Most questions as to the near-future business outlook disappear when the industries have order books as well filled as now. Irrespective of further orders, a high level of industrial operations is assured. Steel mill output is larger than ever before in the country's history, with operations at approximately 96 per cent of capacity, and unfilled orders are estimated to equal two or three months' production. The automobile industry is giving strong support to business. It has speeded production of its new models more rapidly than is customary, and in October has turned out possibly 500,000 cars and trucks compared with 325,000 in the same month last year. Some observers express the opinion that the season is being rushed at the expense of business later on. However, Mr. Knudsen has stated that he expects the automobile plants to begin work next Spring on $500,000,000 worth of parts for airplanes and engines, and it is a reasonable policy to turn out this Winter a larger percentage than usual of the season's motor car production.

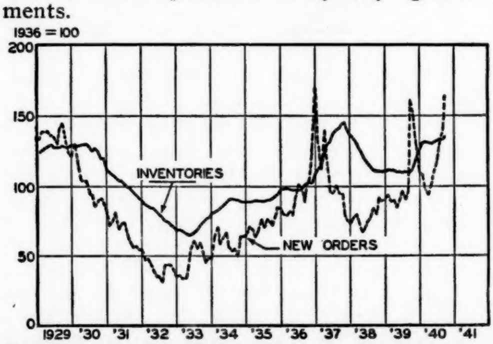
The trend of industrial activity is usually down in November and December. Normal declines are to be expected in industries affected by seasonal conditions, but others evidently will expand production further. If aggregate industrial activity holds at its present rate, seasonally adjusted indexes will advance. It may be confidently assumed that the Federal Reserve Board's index, which was 125 for September (1935-39 = 100), will be higher by the end of the year.

Is Business on A One-Way Track?

A business summary of this kind makes cheerful reading; and this is true even though observers are generally aware that the impetus is coming from the prospect of mounting government expenditures, to be financed largely by debt, — also that the ultimate purpose of the spending is to provide goods which will produce nothing themselves, but which on the contrary will be a drain on all other production for their support. Such considerations are generally ignored in practical calculations, and for the short run it is reasonable to ignore them. The expenditures will support business while they last; they will for the most part counteract or overshadow existing depressing influences, such as the interruption of trade with continental Europe; and the day when they will end is remote. It is not to be wondered that general opinion considers any substantial recession out of the question while the defense program is still expanding, and the arguments for this opinion seem almost irrefutable.

Every business upswing, however, may move too fast at times. This upswing is based upon the requirements for goods and materials for defense purposes, but only a relatively small part of the goods now being produced and on order for the next two or three months is actually passing to the Army and Navy. Much of the buying is anticipatory. Only the event will show whether it has been too fast. The appearance of premiums for spot deliveries and the general lengthening of commitments, at least in the manufacturing industries, are manifestly important developments. Both are evidence of strong demand. But experience shows that when buyers are competing in this way orders in the markets may temporarily become larger than ultimate consumption warrants, and an appearance of scarcity is created which is more illusory than real because the goods are not passing into consumption and because greater production can be made available. Miscalculations of this kind, when widespread, lead to reactions.

Manufacturers' inventories have risen but moderately this year, but were not low to start, after the buying last Fall. The accompanying chart compares the National Industrial Conference Board's index of new orders, already referred to, with an index of inventories of the same manufacturers. At the end of September this index was 6.2 per cent below the 1937 peak. It may be assumed that it will rise, perhaps considerably, during the next few months, as shipments are made against present commitments. The chart shows that such rises have followed previous heavy buying movements.



Manufacturers' New Orders and Inventories (National Industrial Conference Board's indexes, 1936=100)

Of course there are ways in which the present situation differs from 1937 and from other periods when inventories were high. Manufacturers who are buying materials to fill defense orders do not have to worry about over-stocking their distributors, and those who are expanding plant and equipment feel no concern about the market for their product when the plant is ready to go to work. Considering defense requirements, a change of policy from inventory accumulation to liquidation hardly needs to be feared, unless brought on by unpredictable events. But much of the accumulation is not due to defense orders, but to expectation

of generally expanded business. It is never sufficient to say in judging inventories that they are reasonable in relation to sales; the fact is that if sales all around the circle are inflated by inventory accumulation there is a swollen and impermanent element in the demand.

Now that forward commitments have been made, and increased requirements provided for, the situation unquestionably will be strengthened if buying is again dropped back to a consumption basis. Fortunately, there is good reason to hope that this may be the most common policy. There are plainly limits to the inventory risks that business men will assume; all know that war and the effects of war are hard to foresee; and the lessons of 1937 are fresh. Retailers are helping to keep the situation stable by conservative purchases and commitments. Signs were appearing at the end of the month that some of the tension was passing in the markets, and the commodity price advance which had been under way since the middle of August showed signs of flattening out.

Overbuying Contributes to Inflation

The gravest danger of misjudgment and over-anticipation of the effects of the defense program is not that it will lead to an intermediate business recession, which would probably be moderate in extent, but that it may contribute to price rises out of which the dreaded inflationary spiral might develop; or that, alternatively, it will lead to priorities or other controls, which are desirable only in the sense that the inflation spiral is less desirable.

If buyers believe a general change to a sellers' market is taking place, the forward buying move may go a long way and last a long time. But in the great majority of staple commodities it is plain that no general change to a sellers' market is to be apprehended. The problem in foodstuffs and in most farm products is not one of shortage but of surplus. We gave in this Letter last month a discussion of production capacity in lumber, steel and various non-ferrous metals. In these industries producers are confident that they can meet demands provided buying is orderly and not augmented by hoarding or speculation. Surveys of other crude material industries show similar margins of safety.

This is not to say that a complacent view is warranted. The bottlenecks that exist in the provision of tools, and the need of more skilled machinists to make and repair them, are recognized. Mr. Knudsen, speaking of the defense program in New York on October 15, summed up the situation as follows, quoting from a press report:

> We are still in the stages of getting the tools ready for most of the articles. If I could sum it up, it would be something like this: In raw materials we are now getting production, excellent production, of most of the prime raw materials. We are not short of any capacity for some of the finished productions, meaning the articles of wearing apparel, camp equipment and so forth.
>
> However, we are short of tool capacity, and we are going to need all the help that you gentlemen can give us to get the tools ready.

This shortage exists, according to Mr. Knudsen, despite the extraordinary accomplishment of the machine tool industry, which is expanding its output from a normal of $150,000,000 to $200,000,000 in good years of the past to a possible $500,000,000 in 1941.

The need of more tools and highly skilled labor will be felt in many industries making highly finished goods. Expectations that costs of manufacture will increase are fairly widespread. Experience shows, however, that price advances resulting from bottlenecks of this description are less likely to sweep through the markets in a vicious spiral than are inflationary tendencies in crude material prices and general increases in wages. Thus far neither industrial costs nor the cost of living show any general tendency to move up rapidly.

Third Quarter Profits

Reports published during October by leading industrial, railroad and public utility companies covering the third quarter and the first nine months show in most cases an increase in sales or operating revenues over those of a year ago, reflecting the higher level of general business activity. Changes in net profits, however, were highly uneven because of varying costs, taxes and special factors.

Sharp gains in profits were reported in numerous of the capital goods industries having a continued recovery in volume of business, partly due to the war and the national defense program. These include iron and steel, machinery and tools, railway equipment, auto equipment, miscellaneous metal products, chemicals and textiles. Many pulp and paper manufacturers showed marked gains as a result of increased sales of the various paper products, higher prices and limitation of imports by the war. Several coal mining companies turned an operating deficit into a profit, due to better prices and to increased demand, accelerated by the building up of stocks by consumers prior to minimum prices going into effect October 1st.

Lower profits, however, particularly in the third quarter, were reported by many companies in consumers' goods lines, which have received little benefit from the national defense program and are subject to the increased taxes applying to all corporations. This was pronounced in such groups as baking, miscellaneous food products, drugs, soap and petroleum — the latter being affected also by lower gasoline prices, forced curtailment of crude production and loss of export and bunker trade. In these lines, about two-thirds of the reports

issued to date by leading companies show decreased profits in the third quarter as compared with a year ago, despite the generally higher level of sales.

Earnings for Quarter and Nine Months

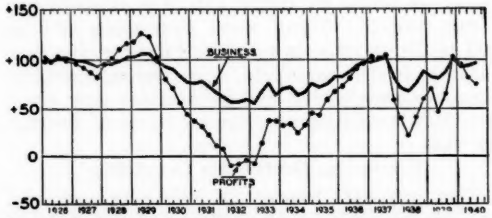
A tabulation of the statements of 350 leading industrial corporations for the third quarter gives combined net profits, less deficits, of approximately $257,000,000 after taxes. This represents a decline of 14 per cent from the $299,000,000 reported by the same companies in the second quarter of this year, but an increase of 23 per cent over the $209,000,000 shown in the third quarter of 1939.

For the first nine months, these companies had combined net profits of $869,000,000, which compares with $611,000,000 in the last year and represents an increase of 42 per cent. The nine months' profits were at an annual rate of 10.4 per cent on the net worth of the group, which aggregated $11,118,000,000 at the beginning of this year, against a return of 7.4 per cent on $10,943,000,000 net worth last year. An accompanying summary gives the results by major industrial groups.

While the reported nine months' figures of most companies are given after reserves for all taxes, a number of companies made no provision for their liability (if any) on excess profits taxes under the Second Revenue Act of 1940 approved on October 8th. Both this law and the Revenue Act of 1940 approved June 25th are retroactive to January 1, 1940, and together they raise the basic rate of corporate normal tax from 18 to 24 per cent, or by one-third. Apparently the benefits from increased volume of sales this year have been offset to considerable extent by the increased taxes, as well as by higher costs and lowered efficiency in some lines where personnel and equipment have had to be expanded rapidly.

Profits Trend in Recent Years

The longer-term trend of profits is shown in the accompanying quarterly index, based upon rate of return on net worth of 200 leading industrial corporations and adjusted for seasonal variation.



Quarterly Index of Industrial Corporations Profits and The Annalist Index of Business Activity. 1926=100

As has been pointed out heretofore, the promptly published reports of leading corporations are useful as indicating profits trends,

PROFITS OF LEADING CORPORATIONS FOR THE FIRST NINE MONTHS

Net Profits Are Shown as Reported, After Depreciation, Interest, Taxes, and Other Charges and Reserves, but Before Dividends. — Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

(In Thousands of Dollars)

No.	Industrial Groups	Net Profits Nine Months 1939	1940	Per Cent Change†	Net Worth January 1 1939	1940	Annual Rate of Return % 1939	1940
8	Baking	$16,028	$13,791	—14.0	$252,638	$245,985	8.5	7.5
16	Food products—misc.	60,187	56,418	— 6.3	624,227	633,217	12.9	11.9
11	Textiles and apparel	5,818	9,146	+57.2	92,752	98,508	8.4	12.4
12	Paper products	3,913	10,523	+	139,419	143,151	3.7	9.8
17	Chemical products	105,004	127,929	+21.8	1,179,048	1,219,827	11.9	14.0
8	Drugs, soap, etc.	27,650	25,923	— 6.2	168,621	169,230	21.9	20.4
14	Petroleum products	49,931	78,662	+57.5	1,523,926	1,554,664	4.4	6.7
18	Stone, clay and glass	20,042	24,281	+21.2	296,417	305,048	9.0	10.6
1	Iron and steel—U. S. Steel	12,391	69,418	+	1,298,907	1,314,807	1.3	7.0
25	Iron and steel—other	21,195	49,693	+	931,711	964,664	3.0	6.9
10	Building equipment	6,183	13,139	+	218,499	210,575	3.8	8.3
14	Electrical equipment	38,983	61,319	+57.3	625,225	636,026	8.3	12.9
25	Machinery	11,098	21,222	+91.2	233,630	227,008	6.3	12.5
7	Office equipment	10,815	12,773	+18.1	149,096	150,705	9.7	11.3
11	Railway equipment	6,179	16,274	+	249,770	237,386	3.3	9.1
1	Automobile—General Motors	109,620	129,172	+17.8	1,027,817	1,053,560	14.2	16.3
7	Automobile—other	31,120	33,925	+ 9.0	213,828	229,061	19.4	19.7
21	Auto equipment	9,740	16,448	+68.9	137,489	144,302	9.4	15.2
31	Metal products—misc.	16,545	31,460	+90.1	223,872	242,582	9.9	17.3
34	Misc. manufacturing	13,139	17,537	+33.5	287,581	282,240	6.1	8.3
291	Total manufacturing	575,581	819,053	+42.3	9,874,473	10,062,546	7.8	10.8
10	Coal mining	D-4,723 *	1,230*	......	215,156	201,314	......	0.8
12	Metal mining	19,020 *	21,582*	+13.5	375,507	377,812	6.7	7.6
11	Mining, quarrying—misc.	12,471 *	15,264*	+22.4	140,679	141,153	11.8	14.4
15	Trade (wholesale & retail)	5,050	7,873	+55.9	195,510	193,186	3.4	5.4
11	Service and construction	3,621	4,367	+20.6	141,278	142,106	3.4	4.1
350	Total	$611,020	$869,369	+42.3	$10,942,603	$11,118,117	7.4	10.4

D- Deficit. * Before certain charges. † Increases or decreases of more than 100 per cent not computed.

but the only measure of average earnings for business as a whole is to be found in the Treasury Department statistics of income based upon all active corporations in the United States. The official figures consistently run below those for leading corporations, and in the years 1931-1933 showed heavy net deficits.

Railroad and Utility Earnings

Gross revenues of the class 1 steam railroads for the first nine months exceeded those of last year by about 8 per cent, with the gain almost entirely in freight revenues.

Despite an increase in operating expenses and taxes, net railway operating income for the first nine months was about 24 per cent higher than a year ago. In contrast with a net deficit after fixed charges of $33,000,000 last year, there was an estimated net income of $52,000,000 this year, which represented, however, an annual rate of return of less than 1 per cent on the shareholders' equity of more than $12,000,000,000.

Further improvement in railroad income is indicated by an increase of 7 per cent estimated by the Shippers' Advisory Boards in freight car loadings for the fourth quarter, with gains estimated for each of the 13 districts, and for 26 of the 29 principal commodity classifications. Relief in the case of a number of railroad problems is hoped for in the Transportation Act of 1940 (Wheeler - Lea Act) approved in September. It is noteworthy also that by the end of this year, the reorganization of a number of railroads, which have been in the hands of trustees for long periods, will have been virtually completed.

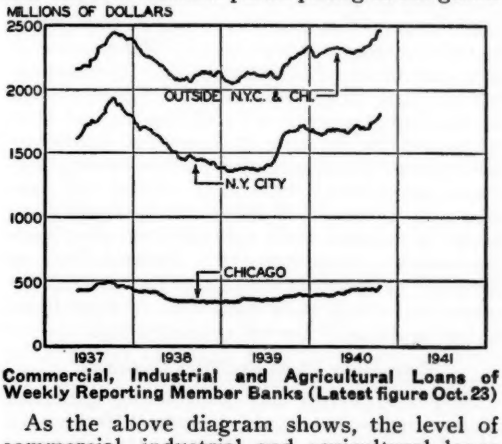
A group of 25 leading public utility systems, supplying electric, gas and other services and reporting for the twelve months ended September 30th, showed an increase of approximately 5 per cent in gross revenues over the same period of a year previous. Because of the rise, however, in operating expenses and taxes — particularly the latter — the net income decreased by 1 per cent.

The American Telephone and Telegraph Company and its principal telephone subsidiaries, reporting for the twelve months ended August 31st, showed an increase of 6 per cent in gross operating revenues. Taxes increased by 16 per cent to a new high (exceeding 15¢ for every $1 of revenue), other operating expenses increased by 3 per cent, and net operating income rose by 6 per cent (before crediting the proportionate interest in earnings of Western Electric Company and other subsidiaries not consolidated).

Money and Banking

Under the combined influence of seasonal demands and the defense program, bank loans to commerce, industry and agriculture have moved up briskly in the past two months. On October 23 the total of these loans outstanding by the weekly reporting member banks was $4,746,000,000, representing increases of approximately $280,000,000 since the end of August and of more than $450,000,000 since the corresponding date of last year. Three years ago, in 1937, when business loans were expanding as a result of rising business activity and mounting inventories, the total of these loans for reporting banks reached a peak of $4,871,000,000. Later, following the collapse of business in the Fall of that year, there was a decline carrying through to a low of $3,745,000,000 in February, 1939. Thus, the latest figures represent a recovery of most of the post-1937 drop, leaving only $125,000,000 to go to duplicate the previous "high".

Of the increase of $1,000,000,000 in reporting bank business loans since the 1939 low, more than half occurred during the last six months of last year, largely after the outbreak of war. The greater part was concentrated in New York City banks and reflected in part the placing of term loans, chiefly for the purpose of retiring outstanding securities rather than for raising new money. This Fall, by contrast, the increase has appeared to be more general in character. While term loans have continued to figure importantly in the totals, there has been evidence of a broader demand for other types of business loans as well. This is suggested not only by the experience of this Bank but by the larger share of the business loan gains reported outside of the principal financing centers. During recent months the increase for reporting banks outside New York City and Chicago has been greater than in the two central reserve cities, with almost all Federal Reserve districts participating in the gains.



Commercial, Industrial and Agricultural Loans of Weekly Reporting Member Banks (Latest figure Oct. 23)

As the above diagram shows, the level of commercial, industrial and agricultural loans of outside reporting banks is now higher than at the 1937 peak, whereas the reverse is still true of reporting banks in New York City and Chicago.

Banks and the Defense Program

Ordinarily the Fall expansion of commercial loans reaches a crest about the middle of October, but this year the conditions are such that ordinary seasonal considerations can hardly be looked upon as a trustworthy guide. Last year, as the above diagram shows, the seasonal upturn of commercial borrowing continued until December, and this year the expanding needs of the defense program seem even more likely to alter the customary seasonal pattern.

The chief reason — apart from the general business rise — for anticipating additional increases in bank loans at this time lies in the recent removal of important barriers to private financing of defense contracts. These barriers have been (1) the inability of manufacturers under the income tax laws and regulations to take adequate tax-free deductions from income to take care of the higher depreciation rate of defense plants; (2) the Vinson-Trammell Act limiting profits on government aircraft and naval contracts; and (3) the provisions of law prohibiting the assignment of claims under public contracts, which had the effect of preventing the use of government contracts as security for bank loans.

In the case of the first two mentioned barriers, it was in many cases unsafe to make loans, even where the manufacturer was willing to take a chance and go ahead, because of the danger of loss in which the bank might be involved. The third mentioned barrier was important in those many cases where the war contract was so large in proportion to the assets of the contractor that the loan was not adequately protected.

Recently, however, all three of these obstacles have been removed. On October 8th the excess profits tax bill was approved, suspending the Vinson - Trammell Act and permitting manufacturers to amortize new defense facilities out of taxable income over a five-year period. And on October 9th the President approved the Assignment of Claims Act of 1940 amending the existing statutes and providing the necessary authority for parties having contracts from the government calling for payments in excess of $1,000 to assign such payments to "a bank, trust company, or other lending agency, including any Federal lending agency." Thus a way has been opened up for concerns having such contracts to take them to the banks and borrow against them.

Emergency Plant Facilities Contracts

However, before the new assignment of claims legislation could become effective in stimulating new construction, it was necessary to develop a form of contract that would be bankable and give adequate protection to all parties. The National Defense Advisory Commission has been working on this for some time, in conjunction with the various other government departments involved, and with the cooperation of the Federal Reserve Board and Banks and the commercial banks. On October 10 a draft, which is considered more or less final in form, was adopted known as the "Emergency Plant Facilities Contract." Stripped of technical details and reduced to the broadest outline, this contract, to be executed by the government contracting officer and the private manufacturer, provides:

(a) For the work to be done and the terms— cost, date of completion, etc.

(b) For reimbursement to the manufacturer by the Government in 60 equal monthly instalments.

(c) For assignment by the manufacturer of these governmental promises to pay to the bank or other lending agency financing the work.

(d) For retention by the manufacturer of title to the plant pending completion of payments at which time title passes to the Government, except that the manufacturer may, if he wishes, buy the property back from the Government at the original cost less depreciation, or, if he thinks this too high, at a price to be agreed upon by negotiation.

In addition to the foregoing, the contract contains numerous safeguards to protect the parties concerned. Thus, to protect the lender, the contract provides that payment shall be made to the assignee without deduction for any governmental claims arising against the assignor out of other transactions. To protect the Government, the manufacturer agrees not to mortgage or encumber the property in any other way, and to see that it is properly insured and maintained.

The advantages of this type of contract are obvious, particularly in cases where the risk of making a large investment that may become useless after completion of the defense program is too great for private capital to assume. These advantages were set forth clearly in the following excerpt from a statement issued by the National Defense Advisory Commission on September 25, last:

> Specifically, the new contract has two purposes: To expedite signing of supplies contracts by the Army and Navy through assuring the contractor against loss on construction undertaken for military purposes; To safeguard the Government's interest in such facilities on termination or completion of the contract.
>
> The plan provides that the Government reimburse the contractor, not in additions to the unit price of the product purchased as heretofore, but in five equal annual installments* covering the amount of his capital expansion costs. Thus, cost of supplies and amortization of construction cost by the Government would be separated. Prices are thereby held at a minimum and, while the manufacturer is relieved of the risk involved in building fixed assets for the emergency, he still absorbs all the ordinary risks involved in production.
>
> In other words, adoption of this plan assures that neither the private manufacturer nor the Government would assume in advance all the risk, nor subsequently

*Since changed to 60 equal monthly installments.

reap as a profit the residual value. The contract contains provisions whereby the contractor may, by purchase or lease from the Government, acquire use of the facilities for himself, after they have served their purpose in connection with emergency defense needs.

It is expected that the plan will conserve government funds and stimulate investment of private capital in the defense construction program. At the same time, private manufacturers would provide management and operation and assume all the ordinary risks of the business. Government participation would be limited to actual expansion costs.

Methods of Financing Defense Construction Summarized

With the setting up of the foregoing plan, four principal methods for building and financing defense facilities may now be summarized:

1. Army and Navy construction, including government arsenals, naval bases, etc., and extension of existing government properties, to be owned and operated by the Federal Government and financed with Federal funds.

2. Construction of plants to be owned by the Government but operated by private manufacturers, as in the case of the Chrysler tank plant and the du Pont powder plant at Louisville, Ky.

3. Construction of unconditionally privately-owned and operated plants, the manufacturer availing himself of the provision of the new excess profit tax law permitting amortization in five years where the plant is certified by the Government as necessary for defense. This may be the procedure where the manufacturer is able to secure private financing, and where there is reasonable assurance that the volume of business in sight is sufficient to enable him to recoup his cost or that the plant can be converted to peace-time use.

4. Cases where risks are too great for private capital to assume alone. In such cases the manufacturer will wish to avail himself of the Emergency Plant Facilities Contract, as just described.

In view of the very great uncertainties of the situation, it seems likely that much of the financing of new defense construction will be done under the new emergency plant facilities contract plan. Incidentally, it should perhaps be stated at this point that the new Assignment of Claims Act also opens the way to the pledging of government contracts as collateral for working capital loans; that is, a contractor having orders for certain supplies for the Government would be able to take these contracts to a bank and borrow against them. Ordinarily, however, this should not be necessary, inasmuch as such loans are usually for short-term and hence can be negotiated in the usual way. Moreover, because of substantial down payments in some instances, such contracts are to a large extent self-financing.

With important obstacles to defense financing cleared away in the manner described, it is expected that the flow of private capital into these uses will steadily increase. Already a number of emergency plant facilities contracts between the Government and manufacturers have been executed, and more are anticipated as the procedure for borrowing against them becomes clarified and experience develops. Banks throughout the country have large quantities of funds available and are eager to put them to work. In September, the National Defense Advisory Commission reported that results of a test survey, conducted through the Federal Reserve System had revealed the commercial banks as standing ready to lend at least $3,000,000,000 to manufacturers for emergency defense plant facilities, "an amount," the Commission said, "several times that which at present is believed required for building emergency production capacity."

With so much private capital available, and with demands upon the Federal Treasury so great, it is clearly desirable that as much as possible of the burden of defense plant expansion should be financed under private auspices. Not only will this be in accord with the tradition of private enterprise, but it will mean less government deficit, and less government bonds to be sold, — hence less of the danger that goes with a rapidly expanding government debt.

Other Money Market Changes

Other money market developments of the month may be reviewed briefly. Apart from the rise of business loans, the principal banking change was the rise of member bank excess reserves to a new all-time high of $6,940,000,000, exceeding for the first time the previous peak of $6,880,000,000 reached last July. It will be remembered that at that time Treasury financing resulted in a considerable shift of funds from the market to the Federal Reserve Banks, reducing excess reserves. Since then, under the influence of Treasury gold purchases and other disbursements from Reserve Bank balances, excess reserves have been gradually recovering, finally setting a new record, with prospect of still further gains so long as the gold movement to this country continues in volume.

Principal offsets to money market gains during the month included a continued rise of currency in circulation, which reached a new peak of $8,265,000,000, and an increase of member bank reserve requirements attendant upon expansion of deposits into new high ground. In line with the policy pursued irregularly over the past year, the Reserve Banks reduced further their holdings of government securities which were built up rapidly at the time of the bond market slump at the outbreak of war in September, 1939, but are now the lowest since October, 1933. This reduction of the Reserve Banks' open market account is generally approved as evidence of a willingness on the part of the Reserve authorities to pursue a two-way policy with respect to fluctuations in govern-

ment security prices, — not only giving support to the market in times of weakness, but also providing some supply of bonds at times when the market demand might push prices to still more abnormal levels and invite disorderly conditions. The only real question is whether it would not have been better for the market if sales over the past year had been carried out more promptly and in larger amounts.

Due partly to the expansion of business loans and partly to a rise in holdings of government securities, total earning assets of reporting member banks continued to increase during October and on the 23rd were at a new high record, up approximately $1,800,000,000 from the corresponding date a year ago.

In the bond market a steady investment demand continues, sustaining high grade bonds around top levels for the year, and absorbing readily the substantial volume of new securities offered. Total corporate financing, including $108,000,000 of refunding bonds of the Southern California Edison Company, reached $360,000,000 in October, the largest for any month since June, 1937. Of the total, however, only $36,000,000 represented new capital, the balance being refunding. Thus "new money" issues dropped considerably as compared with the September quarter when they amounted to $180,000,000 or about a third of all corporate financing for the period. Municipal financing, aggregating $163,000,000, was the largest since February and in general was outstandingly successful.

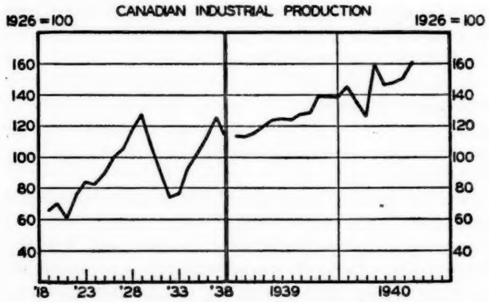
Canada at War

The Canadian war effort, and the ways in which the Canadian Government and people are dealing with the problems raised by the war, deserve close attention in this country. The problems are similar in many ways to those raised by our own defense program, and we can learn from Canadian experience. The military collaboration for defense, as planned by the Joint Defense Board established last August, joins the two countries in a common enterprise. At the same time the effects of the war on Canada's finance and trade are matters in which the American people have not only a sympathetic interest but a direct economic concern. Peaceful and orderly business relations make little news, and the magnitude of our interest in Canada may sometimes be overlooked; but no other nations of the world do as much business with each other as the United States and Canada, and in no other foreign country have the people of the United States as much capital invested, $3,800,000,000 in 1939. One-fourth of Canadian manufacturing, before the war, was carried on by American controlled companies.

The World War had profound effects upon Canadian development, stimulating both industrial and agricultural expansion. Now Canada again is giving aid to the United Kingdom in even more diversified ways and, except for men under arms, on a greater scale. Her industrial development is receiving another great stimulus. She is financing part of Great Britain's war expenditure in Canada, and her political importance is being enhanced. At the same time she needs support from the United States as never before. These are all developments of far-reaching significance.

Plans for Economic Aid to Great Britain

For the first time in her history, Canada entered the war as a sovereign nation, by decision of her own Parliament. She entered it unprepared for war, but with far greater productive power than in 1914. She is no longer chiefly an agricultural country as she was then, but her mining and manufacturing have achieved world importance. Her manufacturing output in 1937 was nearly three times as large as at the outbreak of the World War, and her mineral production has expanded even more. Capital investment in manufacturing has almost doubled, and the power employed has tripled. Her population is half again as large. Her recovery from the depression has been more vigorous than in the United States, although at the outbreak of war her industries were still working well below capacity, and she had 400,000 unemployed. The accompanying chart shows the course of industrial production since the last war.



The strategy of this war has called more for economic than for military assistance from Canada, and her war plans provided for a steady increase in the production of military supplies, to reach its peak in the second or third year of the war. It was intended, however, to interfere as little as possible with normal business, at least until the slack in unused plant capacity and unemployed labor had been taken up. The program followed this course during the first eight months of the war. Control of foreign exchange was promptly enforced in order to prevent flight of capital, and price control measures were set up for use as needed. As a whole, however, business was disturbed relatively little. Industrial activity gradually increased, but only $112,000,-

000 had been spent on defense when the fiscal year came to a close on March 31 last.

The chief military contribution of the Canadians was to be, in view of their excellent air record, the training of the Empire Air Force. The total cost over 3¼ years was to be about \$600,000,000, of which Canada's share was \$350,000,000. Her naval vessels of course were put on war duties, enlistment of forces for overseas service on a voluntary basis was started. One division was sent to England late in 1939, and another has followed.

Speed-Up After the Collapse of France

The collapse of France in June shocked Canada, as it shocked Great Britain, into a new conception of the effort and sacrifice which the war required. On June 20 Parliament passed the National Resources Mobilization Act which placed the entire human and material resources of the nation at the disposal of the Government. Selective conscription of men from 18 to 45 was ordered, though not for overseas service. Defense appropriations for 1940-41 were raised first to \$700,000,000, and are now expected to reach about \$1,000,000,000. On a per capita basis this is more than twice as much as the United States will spend in this fiscal year.

To prevent disruption of production, a newly set up Wartime Industrial Control Board was given almost unlimited power over certain industries for which controllers have been appointed. The work of the Department of Munitions and Supply was decentralized by the establishment of government owned and controlled corporations, headed by prominent business men and operated as non-profit private organizations.

Following these measures, the war effort began to show striking results. By the end of September, the military force was expanded to almost 170,000 men, from 5,000 at the start of the war. Over 100,000 men were enrolled in the Militia (National Guard) and some 32 schools for airmen, out of 83 contemplated, were operating.

The contracts let through the Department of Munitions and Supply, which in April were only \$160,000,000, reached \$524,000,000 at the beginning of October, including \$134,000,000 for British account. Construction projects undertaken by the Canadian and British Governments reached \$225,000,000 by September 30, 1940. Private industry is estimated to have put an additional \$100,000,000 in new plants, machinery and equipment on its own account. As a result the volume of building contract awards, which in the last ten years never reached 40 per cent of the 1929 level, recovered to the predepression level.

Canada Approaching Full Employment

Mining activity, already at a record level before the outbreak of the war, has been stepped up further. The non-ferrous metal output, most of which is sold under contract to the British Government, is running about 10 per cent higher than last year. The Canadian steel industry, the second largest in the British Empire, is working at practical capacity, placed at about 2,360,000 tons a year. The number of unemployed dropped by the end of July to 238,000. Shortages of skilled labor have been reported in some lines, particularly in the machine tool industry, indicating that practically full employment may not be far off. The new high record in industrial production in August, nearly 30 per cent over a year ago, is shown on the chart.

Certain occupations, of course, have been unfavorably affected by the war. The output of passenger cars has been shifted to some extent to the production of mechanized war equipment. In agriculture the war has accentuated the chief problem of the past decade: the lack of export markets. The bumper wheat crop harvested this season has created a serious storage problem, has extended the scope of government subsidies, and will probably necessitate drastic curtailment of acreage next Spring. Abundance of feed has been responsible for the increased output of dairy and hog products, which are, however, finding a better market in Great Britain.

In the long run, it is plain that the effects of the war will be to discourage the growth of agriculture and promote its diversification, as well as stimulating industrialization. The trend will be toward a more desirable balance within the Canadian economy.

Fiscal Policies and Price Controls

This great war effort presents grave economic and fiscal questions to the Canadian Government, which may well be a forecast of our own problems. The first objective is to raise production. The present capacity to produce war materials is now fully employed, and the task is to raise that capacity, — if necessary by diverting labor and machinery from the production of peacetime goods. Fiscal policies need to conform to these requirements. High taxes, especially if imposed upon consumption, reduce the demand for everyday goods and release capacity for the war effort. Likewise, security issues sold to the public concentrate savings into war channels. Financing through credit expansion, on the other hand, adds to aggregate purchasing power, and unless the supply of goods produced can be increased at an equivalent rate the effect is inflationary.

The problem of determining the fiscal policy at the outset of the war was not simple, in view of the slack in production and employment already referred to. The official position was taken that measures which would repress consumption, if prematurely enforced, would tend

actually to restrict capital investment and hinder the desired increase in production. In the budget speech following the declaration of war, the Minister of Finance pointed out that "it would be unwise and probably impracticable to attempt at an early stage any large borrowing operation designed to draw heavily upon public savings." Accordingly, the first financial operation was to borrow from the chartered banks in October $200,000,000 in two-year 2 per cent notes. At the same time the Government increased income, liquor and tobacco taxes substantially and imposed an excess profits tax; but much of the program was aimed at incomes of the following year.

In the same speech, however, the Minister said, "As soon as the expansion of employment and production gets well under way and before it reaches its limits, further expansion of the supply of money and credit must be stopped if the danger of progressive inflation is to be avoided." In January of this year, after the war effort was more definitely under way, the Government appealed for public subscriptions for a $200,000,000 long-term issue, bearing 3¼ per cent interest, and this was oversubscribed by 45 per cent within a few days. In June the Finance Minister made another statement, again expressing the determination of the Government to finance the war effort by increased taxation and by borrowing from the public rather than by expanding bank credit. At the same time further tax increases were imposed. They included a new national defense tax of 2 per cent on all incomes, the reduction of income tax exemptions by 25 per cent, the raising of the excess profits tax from 50 to 75 per cent, and the imposition of a duty of 10 per cent on all non-Empire imports. In September, 1940, a second war loan of $300,000,000 3 per cent 12-year bonds was offered to the public at 98¾, and fully subscribed for.

During the first few months of the war wholesale prices in Canada advanced about 15 per cent. This is not much out of line with the depreciation of the Canadian dollar and the duty on non-Empire imports, which together add about 21 per cent to the cost of these imports. To keep down inflationary tendencies, the Wartime Prices and Trade Board was organized at the beginning of the war and given control over prices of necessities of life, including fuel, wool, leather and sugar. It has had to use its powers only to a limited extent, since world prices have not risen greatly, and since December the price level has been maintained without much change. The cost of living has risen about 5 per cent since August 1939, mostly in the first months of the war. Canadian farm prices declined considerably last Spring, and were in August 1940 only about 7 per cent higher than a year ago.

Balance of Payments with the United States

One of the major problems of Canada's war effort is to find sufficient United States dollar exchange to pay for additional purchases in this country of industrial raw materials, machinery and machine tools; and this is the aspect which is of great concern to this country. From September 1939 to August 1940, the first year of the present war, the Dominion imported from this country about $680,000,000 worth of goods, nearly 60 per cent more than in 1938.

Since the United States has to rely greatly upon Canada for some of the products formerly imported from the Scandinavian countries and certain raw materials needed for national defense, there was also a considerable increase in the Canadian exports to this country. Nevertheless, as will be seen from the table, the Dominion's "unfavorable" balance of trade with us during the first war year rose to $222,000,000 as compared with $154,000,000 in 1938 and $131,000,000 in 1937.

Canadian Foreign Trade During 1938 and the First War Year

(In Millions of Canadian Dollars, excluding gold)

	Calendar Year—1938			First War Year Ended Aug. 31, 1940		
	Exports	Imports	Balance	Exports	Imports	Balance
Great Britain	340	119	+221	450	143	+307
Rest of Empire	103	67	+ 36	126	97	+ 29
Total Empire	443	186	+257	576	240	+336
United States	271	425	—154	458	680	—222
Other Countries	124	67	+ 57	96	72	+ 24
Grand Total	838	678	+160	1,130	992	+138

While the merchandise trade balance is the major factor in the balance of payments some saving probably will be possible in other transactions. The principal source of U.S. dollars, as will be seen from the next table, is American tourist expenditures. They have been disappointing this year, but the restriction of Canadian travel in the United States has probably offset their decline. A considerably larger credit is likely to result during the war from the shipments to this country of newly mined Canadian gold. We are likely to receive not only a larger share of the output, but the production itself is being encouraged and is expected to reach about $220,000,000 (Canadian) this year.

The table shows that Canada has had a varying debit balance in her current accounts with the United States. She has had a large credit balance with Great Britain and the rest of the world, and has used her credits not only to meet her current payments to the United States but also to repay a substantial amount of her public and private debt, both in this country and in Great Britain, and to invest here. In 1938, for example, she not only covered her debit of $133,000,000 on current account here,

Principal Current Items of Canadian-U. S. Balance of Payments

(In Millions of Dollars)

Canadian Credits (net)	1929	1935	1937	1938	1st War Yr.(e)
Tourist trade	201	126	176	167	175*
Gold	75	101	111	64	204†
Total	276	227	287	231	379
Canadian Debits (net)					
Merchandise trade	365	35	107	134	222
Interest and dividends	173	171	200	201	200
Other items	39	21	35	29	30
Total	577	227	342	364	452

Principal Current Items of Canadian-United Kingdom Balance of Payments

(In Millions of Dollars)

Canadian Credits (net)	1929	1935	1937	1938	1st War Yr.(e)
Merchandise trade	74	187	253	220	307
Gold	....	16	32	80	....
Total	74	203	285	300	307
Canadian Debits (net)					
Interest and dividends	113	76	88	82	
Tourist trade & other items	23	13	20	22	
Total	136	89	108	104	100

Source: 1929-1938: Studies of the Dominion Bureau of Statistics; First war year estimated. (e) Estimated. * This estimate is highly tentative, as data for a close estimate are not yet available. † Newly mined gold only.

but exported to us $100,000,000 of capital in addition.

Since the credits earned in Great Britain are no longer available in the form of free sterling exchange convertible into dollars, these triangular transactions are now interrupted. It is possible that some portion of Great Britain's deficit in trade with Canada is being settled in gold; however, it is unlikely that any surplus will be available from this source for the retirement of Canadian debt in the United States. Instead the problem is to keep up current purchases, interest and dividend payments. To make both ends meet, Canada must count on attracting tourist business from this country and reducing her own tourist expenditures here, shipping us her full gold production, and increasing exports wherever possible. If these measures still fall short, liquidation of Canadian-held negotiable United States securities and bank balances in this country, estimated on the basis of U. S. Treasury figures last July at $830,000,000, can produce dollars. Restrictions on imports of American goods of nonessential character can be employed, as well as restriction on transfers of dividends, if necessary. All these measures provide substantial resources, and are a bulwark for the protection of the service of the bonded debt. In 1938 the requirement for interest due to the U. S. was about $95,000,000, out of total interest and dividend payments of $226,000,000.

The situation is not complicated by any considerable debt maturities for some years.

Canada as Creditor of the British Empire

While Canada's import surplus in the trade with us has increased during the war, her export surplus with Great Britain has grown by almost the same amount. Unless Great Britain can increase her exports to Canada, which is unlikely during wartime, she will have to pay for Canadian goods by shipping gold, selling holdings of Canadian securities, or negotiating loans. British investments in Canada amounted to about $2,685,000,000 in 1937. Some $200,000,000 of securities have been sold back to Canada since the war started.

Reduction of Canada's overseas debt, which has thus been accelerated by the war, has been under way since about 1933. Through the '20s Canada borrowed heavily from abroad but after the depression set in her rapidly increasing gold output, together with the reduction of imports, which was in part a consequence of the growth of industries producing for the home market, gave Canada a surplus in her overseas transactions. Between 1930 and 1937 foreign investments in Canada were reduced by about $430,000,000, while Canadian investments abroad increased by about $100,000,000. Now, under war conditions, Canada will have an even larger favorable balance of payments with the British Empire, although a more unfavorable balance with the United States.

These trade and financial statistics show that the war is forging new ties and strengthening the old ones between Canada and the Empire, economically as well as politically; and at the same time, although the statement may seem a paradox, she is being drawn closer to the United States, economically because of reliance upon our industrial plant, and politically because of the common problem of defense. Out of the war undoubtedly will emerge a Canada that is more highly industrialized. While industrialization may make Canada a more active export competitor of the United States, and reduce the post-war market for many of our consumers' goods, it should stimulate Canadian purchases of industrial raw materials such as coal, steel and cotton, and of tools and machinery.

If the conflict lasts Canada may be expected to gain in population, through transfers of skilled labor and refugees from Great Britain and post-war immigration. Her economic structure will be stronger because her dependence upon exports of farm products and raw materials will be lessened. Financially, continuing the trend of the past few years, she will be less dependent upon foreign capital investment. The development of the Canadian economy, now being accelerated by the war, is in fact similar to that of the United States between fifty and twenty-five years ago.

The National City Bank of New York

Head Office · 55 WALL STREET · *New York*

Condensed Statement of Condition as of September 30, 1940

INCLUDING DOMESTIC AND FOREIGN BRANCHES

ASSETS

Cash and Due from Banks and Bankers	$1,285,089,938.73
Gold Abroad or in Transit	621,500.00
United States Government Obligations (Direct or Fully Guaranteed)	778,108,015.75
Obligations of Other Federal Agencies	33,601,904.06
State and Municipal Securities	169,411,300.51
Other Securities	63,960,973.69
Loans, Discounts and Bankers' Acceptances	524,129,037.31
Real Estate Loans and Securities	7,797,910.48
Customers' Liability for Acceptances	4,521,773.26
Stock in Federal Reserve Bank	3,915,000.00
Ownership of International Banking Corporation (Including Paris Office)	8,000,000.00
Bank Premises	41,548,167.99
Other Real Estate	476,706.74
Other Assets	1,237,845.29
Total	$2,922,420,073.81

LIABILITIES

Deposits		$2,740,411,458.45
Liability on Acceptances and Bills	$22,664,975.38	
Less: Own Acceptances in Portfolio	13,502,128.46	9,162,846.92
Items in Transit with Branches		12,220,060.95
Reserves for:		
Unearned Discount and Other Unearned Income		4,008,001.60
Interest, Taxes, Other Accrued Expenses, etc.		7,855,817.91
Dividend		1,550,000.00
Capital	$77,500,000.00	
Surplus	53,000,000.00	
Undivided Profits	16,711,887.98	147,211,887.98
Total		$2,922,420,073.81

Figures of Foreign Branches are as of September 25, 1940.
(Brussels as of September 21)

$72,906,991.34 of United States Government Obligations and $27,386,169.12 of other assets are deposited to secure $75,600,711.82 of Public and Trust Deposits and for other purposes required or permitted by law.

(Member Federal Deposit Insurance Corporation)

City Bank Farmers Trust Company

Head Office · 22 WILLIAM STREET · *New York*

Condensed Statement of Condition as of September 30, 1940

ASSETS

Cash and Due from Banks	$ 54,020,701.95
United States Government Obligations (Direct or Fully Guaranteed)	32,305,211.77
Obligations of Other Federal Agencies	2,211,315.36
State and Municipal Securities	8,312,315.12
Other Securities	1,828,172.19
Loans and Advances	6,446,356.15
Real Estate Loans and Securities	5,544,599.96
Stock in Federal Reserve Bank	600,000.00
Bank Premises	3,929,726.25
Other Real Estate	400,346.24
Other Assets	1,629,400.52
Total	$117,228,145.51

LIABILITIES

Deposits	$ 90,589,245.37
Reserves	1,583,972.63
Capital	10,000,000.00
Surplus	10,000,000.00
Undivided Profits	5,054,927.51
Total	$117,228,145.51

$1,585,639.94 of United States Government Obligations are deposited with public authorities for purposes required or permitted by law.

(Member Federal Deposit Insurance Corporation)

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d in U.S.A.